UNITED STATES DISTRICT COURT FOR THE
DISTRICT OF NEW JERSEY

JOSEPH STECHLER; GAIL STECHLER; and STECHLER & CO., INC. f/k/a JOSEPH STECHLER & CO., INC, Plaintiffs,	CIVIL ACTION NO. 05-3485 (HAA)
- against -	HON. HAROLD A. ACKERMAN, U.S.D.J.
SIDLEY AUSTIN BROWN & WOOD LLP; R.J. RUBLE; ALPHA CONSULTANTS, INC.; ALPHA CONSULTANTS, L.L.C.; IVAN ROSS; IRWIN ROSEN; GRANT THORNTON, L.L.P.; GRANT THORNTON INTERNATIONAL; ISRAEL PRESS; REFCO CAPITAL MARKETS, LTD.; and REFCO CAPITAL LLC, Defendants.	Return Date: September 26, 2005

SIDLEY AUSTIN BROWN & WOOD LLP'S MEMORANDUM IN OPPOSITION TO PLAINTIFFS' MOTION TO REMAND

LUM, DANZIS, DRASCO, POSITAN
& KLEINBERG, LLC
103 Eisenhower Parkway
Roseland, New Jersey 07068-1049
(973) 403-9000

MUNGER, TOLLES & OLSON LLP
355 South Grand Avenue
35th Floor
Los Angeles, California 90071-1560
(213) 683-9100

COVINGTON & BURLING
1330 Avenue of the Americas
New York, New York 10019
(212) 841-1000

DENNIS J. DRASCO (DD-2022)
KEVIN J. O'CONNOR (KO-9378)
Of Counsel and On the Brief

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Defendant Sidley Austin Brown & Wood LLP ("Brown & Wood") respectfully submits this memorandum in opposition to Plaintiffs' Motion To Remand. Brown & Wood opposes Plaintiffs' motion without waiver of its right to seek arbitration of Plaintiffs' claims.

PRELIMINARY STATEMENT

The Court has federal question jurisdiction in this action because Plaintiffs' claims arise under federal law. A suit alleging state-law claims arises under federal law where the plaintiff's right to relief on any one of the state-law claims depends on a substantial question of federal law. Because that is the situation here, Plaintiffs' remand motion should be denied.

Plaintiffs' suit stems from their participation in a "Digital Options Strategy" in an attempt to avoid paying federal taxes on large capital gains realized in 2000. Complaint ¶¶ 24, 26, 48-49. Unhappy with the results of that transaction, Plaintiffs have brought this action against parties who allegedly advised them or implemented the transaction to recover the costs associated with the strategy, plus back taxes, interest, and penalties paid by Plaintiffs pursuant to a settlement with the IRS. Although Plaintiffs assert various common law claims – including fraud, negligent misrepresentation, breach of fiduciary duty, and malpractice – the core of each claim consists of Defendants' alleged erroneous representations about the federal tax law treatment of the Digital Options Strategy. In order to prevail on their claims, Plaintiffs must prove that Defendants' advice and opinions regarding federal tax law were wrong. Plaintiffs cannot, however, prove this assertion without asking the Court to construe the federal tax code and regulations. Plaintiffs' claims therefore turn on the construction of federal tax law.

The United States Supreme Court recently upheld federal question jurisdiction where a state-law claim turns on a substantial question of federal law. *See Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 125 S. Ct. 2363 (2005). The Supreme Court specifically found federal question jurisdiction over state-law claims turning on disputed issues of federal tax law. In affirming federal jurisdiction, the Supreme Court emphasized:

> The national interest in providing a federal forum for federal tax litigation is sufficiently substantial to support the exercise of federal question jurisdiction.

Grable, 125 S.Ct. at 2365. The Supreme Court's decision in *Grable* was promptly followed by a district court's rejection of remand in *Becnel v. KPMG LLP*, No. 05-6015, 2005 WL 2016246 (W.D. Ark. June 21, 2005)[1] – a case involving similar parties and allegations to the case at hand. The same result should be reached here.

PLAINTIFFS' COMPLAINT[2]

On June 14, 2005, Plaintiffs filed their Complaint in the Superior Court of New Jersey, Bergen County, against Brown & Wood; R.J. Ruble; Alpha Consultants, Inc.; Alpha Consultants, LLC; Ivan Ross; Irwin Rosen; Grant Thornton, LLP; Grant Thornton International; Israel Press; Refco Capital Markets, Ltd.; and Refco Capital LLC.[3] Brown & Wood timely removed the suit on July 11, 2005. Plaintiffs have not effected service of process on Brown & Wood or, upon information and belief, on any other Defendant.

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[1] Another district court, disagreeing with *Becnel*, ruled that it did not have jurisdiction over a similar case. *See Sheridan v. New Vista, L.L.C.*, No. 1:05-CV-428, 2005 WL 2090898 (W.D. Mich. Aug. 30, 2005). For the reasons stated in this Memorandum and in the *Becnel* decision, Brown & Wood believes that *Sheridan* was wrongly decided.

[2] Brown & Wood does not admit any of the factual allegations in the Complaint and expressly reserves the right to contest those allegations at the appropriate time.

[3] Plaintiffs previously filed a similar complaint in the United States District Court for the Southern District of New York. That complaint asserted a claim under the Racketeering Influenced Corrupt Organizations ("RICO") Act, 18 U.S.C. § 1961, *et seq.*, as the basis for federal jurisdiction. The RICO claim was dismissed by the Court on April 5, 2005. *See Stechler v. Sidley Austin Brown & Wood, L.L.P.*, No. 04 CV 5923 (SAS), 2005 WL 774264, at *12 (Apr. 5, 2005). The district court then dismissed without prejudice the remaining state-law claims after declining to exercise supplemental jurisdiction. *See id.* The court's dismissal was prior to the *Grable* decision and the court did not address whether it had federal question jurisdiction over the state-law claims. Rather than replead in federal court in New York, Plaintiffs chose to bring this action in state court in New Jersey.

The Complaint alleges that Plaintiffs Joseph Stechler and Stechler & Co. incurred large capital gains in 2000 as a result of the sale of certain stock holdings. Complaint ¶ 48. Later that year, Mr. Stechler allegedly had several meetings with his long-time accountants, Defendants Press and Grant Thornton, to discuss the tax implications of these capital gains and to develop a tax plan. *See id.* ¶¶ 47-48. Plaintiffs agreed to participate in the Digital Options Strategy in November 2000, *see id.* ¶ 92, and Plaintiffs executed the Strategy in November and December 2000, *id.* ¶¶ 93-105. Brown & Wood provided a tax opinion letter to Plaintiffs in February 2001. *See id.* ¶ 116; Declaration of Kevin J. O'Connor ¶ 2, Exhibit 1 ("Opinion Letter"). The Opinion Letter is a highly detailed, 103-page legal analysis of the federal tax implications of the Digital Options Strategy, and it concludes that the proposed tax treatment would be "more likely than not" to be upheld by a federal court in the event of an IRS challenge. *Id.* ¶ 117; Opinion Letter at 6-8. Plaintiffs utilized the losses generated by the strategy on their 2000 federal income tax returns. *See id.* ¶ 120. According to the Complaint, the IRS promulgated certain regulations and notices in 2003 and 2004 that invalidated the Digital Options Strategy, and Plaintiffs subsequently settled with the IRS by paying back taxes, interest, and a 10% penalty. *See id.* ¶¶ 140-46.

The Complaint asserts various common law claims, including fraud, negligent misrepresentation, malpractice, and breach of fiduciary duty. In support of these claims, Plaintiffs make numerous allegations concerning federal tax law and numerous allegations that Defendants' statements and advice concerning federal tax law were false. *See, e.g.*, *id.* ¶¶ 33, 34, 67, 83, 87, 91, 107-115, 117, 121, 125, 126, 131, 132, 140-144, 162, 167, 175, 176, 186, 187, 195, 197. The critical charging paragraphs of Plaintiffs' claims allege myriad statements by Defendants concerning federal tax law and allege that these statements were "inaccurate, improper, wrong and/or false." *Id.* ¶ 187; *see also id.* ¶¶ 186, 166-67, 175-76. These allegedly false representations include statements concerning whether the Digital Options Strategy was legal, whether it was consistent with the federal tax code and regulations, whether certain IRS Notices foreclosed the strategy, whether the transaction would be disallowed for federal tax purposes, and whether the strategy was more likely than not to be upheld by a court. *See, e.g., id.* ¶¶ 166(16), 166(20), 166(23)-(24), 166(35), 166(37), 166(40)-(45), 166(47)-(48), 166(51), 166(57)-(60), 166(63), 166(67). Thus, the core of this case is the claim that Defendants' advice regarding federal tax law was wrong.

ARGUMENT

I. Federal Jurisdiction Is Proper Because Plaintiffs' Claims Necessarily Turn On A Substantial Question Of Federal Law.

Although federal question jurisdiction under 28 U.S.C. § 1331 typically involves the assertion of federal causes of action, the Supreme Court recently held that state-law claims trigger federal question jurisdiction where the plaintiff's success on any claim depends upon the construction or application of a substantial and disputed issue of federal law. *See Grable*, 125 S.Ct. at 2366-68; *see also U.S. Express Lines Ltd. v. Higgins*, 281 F.3d 383, 389 (3d Cir. 2002). Under this doctrine, the federal courts have subject matter jurisdiction where (1) at least one claim in the complaint depends upon the construction or application of federal law; (2) the disputed federal issue is "substantial"; and (3) the exercise of jurisdiction is consistent with the congressionally approved balance of federal and state judicial responsibilities. *Grable*, 125 S.Ct. at 2368.

The Supreme Court's recent decision in *Grable* illustrates these principles. In that case, the plaintiff brought a state-law quiet title action regarding certain real property, which had been the subject of a seizure to satisfy a federal tax deficiency. To prevail on the state-law quiet title claim, the plaintiff needed to prove that certain requirements of the federal tax law had not been met in passing title to the defendant. Because the resolution of the plaintiffs' state-law claim required the court to construe federal tax law, and recognizing the substantial national interest in providing a federal forum for uniform resolution of federal tax law issues, the Supreme Court affirmed the assertion of federal jurisdiction. *Id.* at 2368-71.

A. Plaintiffs' Claims Depend On A Construction of Federal Tax Law.

In order to prevail on their fraud and negligent misrepresentation claims, Plaintiffs must prove, among other elements, that Defendants' alleged representations regarding federal tax law and the likely federal tax treatment of the Digital Options Strategy were false. *See, e.g.*, *Kaufman v. i-Stat Corp.*, 754 A.2d 1188, 1195-96, 165 N.J. 94, 109 (N.J. 2000); *Hausler v. Spectra Realty, Inc.*, 188 A.D.2d 722, 723, 590 N.Y.S.2d 587, 588 (N.Y. App. Div. 1992). To do so *requires* construction of federal tax law.

Plaintiffs' other claims are based on the same alleged failure to provide accurate federal tax law advice and a legitimate transaction under federal law. These allegations are proven *only* if Plaintiffs can establish that the tax advice was improper under federal tax law. Accordingly, all of Plaintiffs' claims turn on a question of federal law and remand is inappropriate. *See, e.g.*, *Broder v. Cablevision Sys. Corp.*, 418 F.3d 187, 195-96 (2d Cir. 2005) (applying *Grable* to uphold federal jurisdiction of breach-of-contract claim that required the plaintiff to prove that the defendant failed to comply with a federal statute governing cable television rates, which was incorporated by reference into the contract); *Additive Controls & Measurement Sys., Inc. v. Flowdata, Inc.*, 986 F.2d 476, 478-79 (Fed. Cir. 1993) (federal jurisdiction existed and remand rejected where disparagement claim required showing of a false statement and falsity turned on construction of federal patent law); *Christopher v. Cavallo*, 662 F.2d 1082, 1083-84 (4th Cir. 1981) (federal jurisdiction existed and remand rejected where breach of warranty claim turned on construction of federal copyright law); *Air Measurement Techs., Inc. North-South Corp. v. Hamilton*, No. SA-03-CA-0541-RF, 2003 WL 22143276, at *3 (W.D. Tex. Sept. 5, 2003) (federal jurisdiction existed and remand rejected where malpractice claim turned on construction of federal patent law).

Plaintiffs concede that IRS notices, "federal regulations," and federal case law are "involved" in some of their claims, but assert that the "federal issue is not contested," apparently by Plaintiffs and the IRS. Plaintiffs' Br. at 4 & n.1. In particular, Plaintiffs argue that there is no "substantial dispute or controversy" concerning the content, validity, construction, or effect of IRS Notices 1999-59 and 2000-44 because the Notices were subsequently "enacted as IRS regulations giving them the force of law." *Id.* Thus, they conclude that "there is no dispute as to issues of federal law as the law is established by these regulations." *Id.*

This argument fails for at least two reasons. The federal questions in this case turn on Defendants' advice regarding the law at the time of the transactions in 2000, not what the IRS may have enacted in 2003 to "formalize its position." Complaint ¶ 140. Further, the Notices existed *prior* to Plaintiffs' execution of the Digital Options Strategy, and their validity, meaning, and applicability to Plaintiffs' transactions were discussed in Brown & Wood's Opinion Letter. Complaint ¶ 118; Opinion Letter at 63, 71-76. A key federal issue in this case is whether Defendants' tax advice concerning the tax analysis in and impact of the Notices was false. That issue cannot be resolved by mere citation to the IRS Notices themselves.

Finally, this Court should not follow the recent decision in *Sheridan v. New Vista, L.L.C.*, No. 1:05-CV-428, 2005 WL 2090898 (W.D. Mich. Aug. 30, 2005). The *Sheridan* court rejected federal jurisdiction in a case involving an allegedly illegal tax shelter primarily on the ground that the case required resolution of the reasonableness of the defendants' interpretation of federal tax law, but not the proper interpretation of federal tax law itself. *See id.* at *4. This reasoning is unsound because the court – like Plaintiffs here – overlooked the fact that the plaintiffs must *first* prove, as an element of their claims, that the federal tax advice provided by the defendants was false. The reasonableness of Defendants' interpretation of the law is a separate element which is relevant only if Plaintiffs demonstrate that the federal tax advice was false. *See Broder*, 418 F.3d at 195-96 (holding that the existence of a potentially determinative state-law issue does not negate federal jurisdiction where a substantial federal issue is a necessary element of the plaintiff's claims). As the *Becnel* court explained: "In order for Plaintiffs to prevail on their state law claims, a determination must be made as to the legitimacy, or legality, of [the tax strategy]." *Becnel*, 2005 WL 2016246, at *2. This Court should follow *Becnel* here.

B. There is a "Substantial" Interest in Having Federal Courts Interpret the Federal Tax Code.

Plaintiffs argue that even if their claims turn on issues of federal law, those issues are not "substantial," as required by *Grable*. Plaintiffs' Br. at 4. In fact, *Grable* confirms that "[t]he meaning of [a] federal tax provision is an important issue of federal law that sensibly belongs in a federal court." 125 S.Ct. at 2368. The Court grounded this holding in "the national interest in providing a federal forum for federal tax litigation." *Id.* at 2365. The Court's conclusion "captures the commonsense notion that a federal court ought to be able to hear claims recognized under state law that nonetheless turn on substantial questions of federal law, and thus justify resort to the experience, solicitude, and hope of uniformity that a federal forum offers on federal issues." *Id.* at 2367. The Supreme Court emphasized in *Grable* that there is a "clear interest" in "the availability of a federal forum" for claims turning on federal tax law and "there is no good reason to shirk from federal jurisdiction over the dispositive and contested federal issue at the heart of [such a] state-law [ ] claim." *Id.* at 2371.

The substantial federal interest in federal judicial review of issues under the federal tax code has long been recognized. Congress had previously mandated that "[t]he district courts shall have original jurisdiction of any civil action arising under any Act of Congress providing for internal revenue," (28 U.S.C. § 1340) and a number of courts — including the U.S. Supreme Court — had previously recognized the substantial interest in "the proper interpretation and uniform application of the Internal Revenue laws." *E.g., Turnbow v. Commissioner of Internal Revenue*, 368 U.S. 337, 339 (1961).

Plaintiffs attempt to distinguish *Grable* on the ground that the tax issue in *Grable* was the sole issue in the case. *See* Plaintiffs' Br. at 6; *see also Sheridan*, 2005 WL 2090898, at *4 (purporting to distinguish *Grable* on the same ground). But nothing in *Grable* or in the federal question jurisprudence of the Supreme Court or the Third Circuit requires that the federal question be the only issue in dispute. The federal issue merely needs to be "substantial." *Grable*, 125 S.Ct. at 2368; *see also U.S. Express Lines*, 281 F.3d at 389 ("It is sufficient that the merits of the litigation turn on a substantial federal issue that is an element, and an essential one, of the plaintiff's cause of action.") (internal quotation marks omitted). As explained above, the federal tax issue in this case satisfies the substantiality requirement.

C. Federal Jurisdiction in this Case Will Not Result in a Flood of Federal Cases.

Plaintiffs argue that even if there is a substantial and contested federal issue in this action, denying remand would open "the flood gates of federal jurisdiction" and thus not be "'consistent with congressional judgment about the sound division of labor between state and federal courts governing the application of § 1331.'" Plaintiffs' Br. at 6, 5 (quoting *Grable*, 125 S.Ct. at 2367). These fears are unfounded.

The limitation on federal question jurisdiction identified in *Grable* – that the exercise of federal jurisdiction must not conflict with the "congressionally approved balance of federal and state responsibilities" – rests on the principle that the limited jurisdiction of the federal courts should not be undermined by federalizing large numbers of garden-variety state-law claims. *Grable*, 125 S.Ct. at 2367-68, 2370-71; *see Merrell Dow v. Thomson*, 478 U.S. 804, 810-12 (1986). In *Merrell Dow*, for example, the Court rejected federal jurisdiction of state tort claims alleging violations of federal drug labeling regulations because federal jurisdiction over such a "tremendous number of cases" would "have heralded a potentially enormous shift of traditionally state cases into federal courts." *Grable*, 125 S.Ct. at 2370-71.

These concerns are absent here. Contrary to Plaintiffs' argument, it will be "the rare state [fraud or malpractice] action that involves contested issues of federal law." *Grable*, 125 S.Ct. at 2371. A typical malpractice case does not present substantial or difficult questions of federal law. For example, in *Diaz v. Sheppard*, 85 F.3d 1502 (11th Cir. 1996), the court rejected federal jurisdiction over a legal malpractice claim, even though the suit involved an attorney's representation of a client in litigation pursuant to a federal statute. The court held that there was "[n]o substantial question of federal law" at issue in the case, because the lawyer's alleged negligence consisted of "settl[ing] too cheaply," ignoring a body of established case law, and erroneously evaluating expert testimony. *Id.* at 1505-06.

This case and other similar tax strategy cases do not involve run-of-the-mill state-law claims. The interest in having federal courts adjudicate the federal tax issues here is as strong, if not stronger, than in *Grable*. A sister federal district court, following *Grable*, has confirmed this result in a recent order in *Becnel*, 2005 WL 2016246. The *Becnel* court upheld federal question jurisdiction and rejected remand in a case involving similar allegations and defendants as in this case.

II. The Court Should Exercise Supplemental Jurisdiction Over Any Remaining Claims.

Every claim in Plaintiffs' Complaint raises a substantial question of federal law. But the law is clear that so long as any single claim raises a substantial federal question, supplemental jurisdiction may (and here should) be exercised over any remaining claims. *See* 28 U.S.C. § 1367; *City of Chicago v. International Coll. of Surgeons*, 522 U.S. 156, 164-65 (1997). Plaintiffs' claims arise from a common nucleus of operative facts: they all relate directly to Plaintiffs' participation in the Digital Options Strategy, and "[Plaintiff] would ordinarily be expected to try them all in one judicial proceeding." *United Mine Workers v. Gibbs*, 383 U.S. 715, 725 (1966). Likewise, it would make little sense to leave some of Plaintiffs' claims in federal court, while others raising the same issues are adjudicated simultaneously in state court. *See, e.g., City of Chicago*, 522 U.S. at 165 (supplemental jurisdiction properly exercised where state-law claims and federal claims all arose from same general set of facts). The Court should exercise its supplemental jurisdiction to the extent any claims fall outside the scope of federal jurisdiction.

CONCLUSION

For the foregoing reasons, Plaintiffs' Motion To Remand should be denied.

Respectfully submitted,

LUM, DANZIS, DRASCO, POSITAN
& KLEINBERG, LLC

By: *s/ Kevin J. O'Connor*
KEVIN J. O'CONNOR
A Member of the Firm

Brad D. Brian
Richard E. Drooyan
MUNGER, TOLLES & OLSON LLP
355 South Grand Avenue
35th Floor
Los Angeles, California 90071-1560
(213) 683-9100
(pro hac vice applications to be submitted)

Aaron R. Marcu
Andrew A. Ruffino
Jason P. Criss
Philip A. Irwin
COVINGTON & BURLING
1330 Avenue of the Americas
New York, New York 10019
(212) 841-1000
(pro hac vice applications to be submitted)

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